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August 8, 2002

Mary Cottrell
Secretary
Department of Telecommunications and Energy
One South Station – 2nd Floor
Boston, MA 02110

Re: Comments in Docket DTE 02-40

Dear Secretary Cottrell,

Please find enclosed one original and ten copies of the comments of Centrica North America in Docket DTE 02-40. An electronic copy has been sent via e-mail to dte.efiling@state.ma.us.

Should you have any questions or comments regarding this filing, please do not hesitate to contact me.

Best regards,

Kevin Wellenius

Centrica North America

Comments in DTE 02-40

August 8, 2002

Executive Summary

The Electric Restructuring Act envisions a move from regulated retail service to "a framework under which competitive producers will supply electric power and customers will gain the right to choose their electric power supplier."[1] Competition at the retail level was established as a natural complement to the deregulation of wholesale markets, and is necessary to ensure that the benefits from competition flow to all electricity consumers.

A properly defined vision for future retail competition includes multiple retailers and a minimal reliance on default mechanisms. To achieve a meaningful transition to a competitive retail market, fundamental changes to the market structure will be necessary. Central to this transition is the need to attract new retailers to the market through preservation of adequate business opportunities during the transition process. This must be balanced with a need to protect customers while competitive discipline develops.

Centrica proposes a transitional default service mechanism that achieves these dual aims, while creating an explicit role for new retailers to facilitate entry. The proposal defines a two-year, fixed price default service designed to mirror the pricing that a competitive new entrant would offer. This ensures that competitive retailers will be able to compete with default prices, which will encourage continued market entry and development of a robust competitive retail market over the transition period.

Default service would be provided by competitive retailers rather than distribution utilities. Default customer accounts would be transferred to these default retailers through a retail auction mechanism. The auction reveals the value of the customer relationship to retailers, and auction revenues would be returned to consumers through a monthly rebate to their electricity bills. Competition would thus be enabled, delivering long-term benefits to customers while auction revenues yield immediate benefits during the transition period.

This proposal protects customers during the transition while giving retailers and customers valuable experience with the new relationships intrinsic to a competitive retail market.

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[1] Electric Restructuring Act, G.L. c. 164, §1(c).

Centrica North America

Comments in DTE 02-40

August 8, 2002

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1 Introduction

Centrica North America appreciates the opportunity to participate in the investigation initiated by the Department of Telecommunications and Energy (“the Department”) regarding default service in the Commonwealth of Massachusetts.

Centrica North America is participating in the Department's investigation precisely because, in its view, the design of default service is critical to the success of competition in the Massachusetts retail electricity market. We look forward to a continuing and constructive dialogue with the DTE and other stakeholders regarding the issues raised in these proceedings.

1.1 About Centrica North America

Centrica North America encompasses the North American operations of Centrica plc ("Centrica"). Centrica is the leading supplier of energy and essential home and highway services for British consumers, employing approximately 30,000 people. Centrica's businesses include energy supply and home services under the British Gas and Scottish Gas brands; automobile services under the AA brand; insurance and financial services under the AA and Goldfish brands; and telecom services under the British Gas and One.Tel brands. Worldwide, Centrica has approximately 44 million customer relationships. For the financial year ended December 31, 2001, Centrica reported sales of approximately £12.6 billion (US $17.6 billion).

Centrica entered the North American retail energy market in 2000. Since that time, through both organic growth and acquisitions, Centrica North America has grown to an enterprise with approximately 3.7 million customer relationships. In the United States, Centrica North America has, through its subsidiaries, become one of the largest multi-state providers of deregulated energy services, with more than 600,000 customers located principally in Georgia, Michigan, Ohio, Pennsylvania, and Texas. In April 2002, Centrica North America announced a deal with American Electric Power to acquire over 800,000 residential and small commercial electricity customers in Texas.

1.2 Background

On June 21st, the Department of Telecommunications and Energy issued an order opening an inquiry into the provision of default electricity service in the Commonwealth.[2] In the June 21st Order, the Department stated its intent to "investigate all aspects of the manner in which default service is provided to ensure that it is compatible with the development of an efficient market", and that this review was necessary to "ensure the benefits of a competitive market are available to all Massachusetts customers at the end of the standard offer service transition period."[3]

In opening this investigation, the Department has recognized two important facts. First, that the existing arrangements for default service may not be appropriate. At present, the number of customers supplied on default service is limited: most residential and smaller commercial customers are served under Standard Offer tariffs. What may be workable today may not be appropriate by 2005, when Standard Offer ends and default service load and customer numbers will expand significantly. Second, the Department has recognized that although retail competition is working well for larger customers, the retail market for residential and small commercial customers has not flourished, and smaller customers have not benefited proportionally. This is contrary to the intent of the Electric Restructuring Act, in which the benefits of competition are to extend to all customer classes.

1.3 Organization of these comments

These comments are organized around a set of key questions. The answers to each of these questions will, in our view, define the appropriate goals of the default service mechanism and help specify its design. These questions are:

- Should there be substantial retail competition for small customers in Massachusetts, or should regulated default service remain the primary manner in which these customers are served? (Section 2);
- What end-state is envisioned for retail competition? (Section 3);
- What are the critical elements of a transitional mechanism? (Section 4);
- Is there an example of a successful default service mechanism? (Section 5); and
- Centrica's proposal for the transitional default mechanism is outlined in Section 6.

In the final section, we review this proposal against the criteria specified in the June 21st Order and the Act to ensure that it meets key policy objectives of the Commonwealth.

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2 Department of Telecommunications and Energy, *Order Opening Investigation into the Provision of Default Service*, Docket D.T.E. 02-40, June 21st, 2002 ("June 21st Order").

3 June 21st Order at 1.

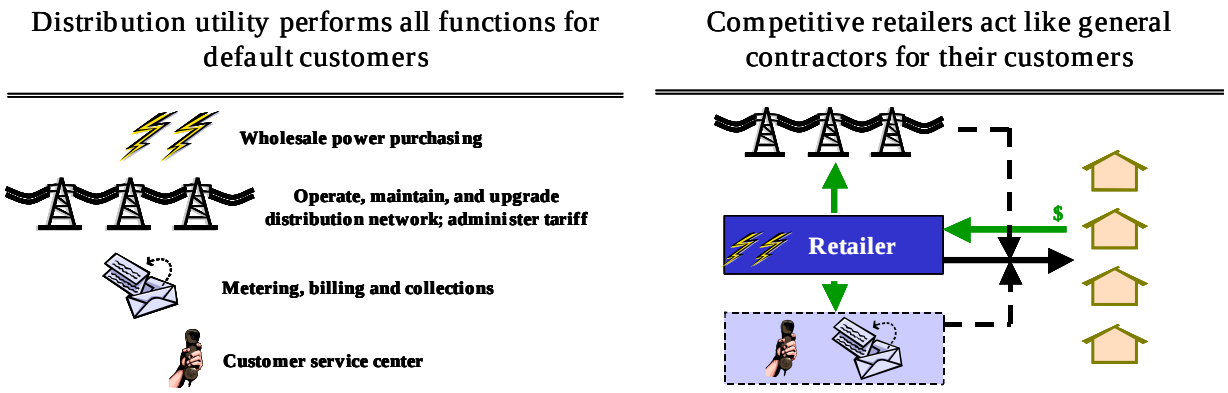
This proposal has been crafted with attention to the specific legislative and regulatory circumstances surrounding retail competition in Massachusetts. Centrica North America recognizes that in other jurisdictions, with different market structures and at another stage of market development, other approaches to the provision of default service (or its equivalent) may be more appropriate.

2 Should there be widespread retail competition for small customers?

Much of the current debate over default service in Massachusetts centers on two different views of the future. In the first view, default service would be a backstop service, provided as a necessary customer protection but used by relatively few customers and for a limited period. The primary means for securing benefits for smaller customers will be a competitive and robust retail market, in which suppliers compete to attract customers based on price and service. These retailers act as intermediaries between the customer and the provider of generation, distribution and other services, as shown on the right-hand side of Figure 1.

In the second view, on the left-hand side of Figure 1, retail competition for small customers is expected to provide few benefits. Default service, instead of being a backstop mechanism, is the *primary* means for serving smaller customers, whether it is arranged through the incumbent distributor or through a designated third-party. Needless to say, it is difficult to define an appropriate default service mechanism until one has a view of what role it is meant to play.

Figure 1: Retail competition changes how services are provided to customers



The remainder of this section examines both the legislative basis and the economics of default supply. We conclude that default service should be viewed as a protective measure associated with the transition to competition, rather than as the primary means of serving customer loads over the long-term.

2.1 Legislative objectives for restructuring

It is instructive to examine the means through which restructuring is meant to provide benefits to customers. In this regard, the legislative intent of the Electric Restructuring Act is clear. Retail competition is viewed as the critical component for delivering benefits to all customer classes:

- "ratepayers and the commonwealth will be best served by moving from the regulatory framework existent on July 1, 1997…to a framework under which competitive producers will supply electric power and customers will gain the right to choose their electric power supplier";[4] and
- "*long-term* rate reductions can be achieved most effectively by increasing competition and enabling broad customer choice in generation service, thereby allowing market forces to play the *principal role* in determining the suppliers of generation for all customers."[5]

As these excerpts from the preamble to the Act make clear, retail competition is defined as the key mechanism for bringing long-term benefits to all customers. Default service is and should remain an important customer protection for the transitional period, as is described in the Act. However, it must be recognized that default service – under the framework in which the Legislature defined it in 1997 – is not the primary means for providing sustainable rate reductions to Massachusetts' customers. Instead, competitive retail service is to be the principal mechanism for achieving rate reductions. Default service, as was noted in the June 21st Order, must be "compatible with the development of an efficient competitive market" rather than attempting to substitute for it.

2.2 Economic analysis of small customer supply

Supporters of a model in which default service is the primary means for serving small customers often suggest that there are characteristics of natural monopoly in procuring and supplying power to these customers. If this were true, then a default service model focused on competitive wholesale procurement could indeed be appropriate.

However, there are few solid arguments that suggest default supply has the economies of scale and scope that characterize a true natural monopoly, or that the scale of existing suppliers is in any way efficient. Consider the wholesale procurement function first: will a small wholesale purchaser be at a relative disadvantage to a large one? If so, at what size is this scale advantage exhausted? Given the emergence of deregulated wholesale markets, we would expect such advantage to exist if these markets are not competitive. We would also expect some advantages to arise from customer diversification. In other words, a large retailer may have some of its forecasting errors balance out, as some loads are overestimated while others are underestimated, whereas a small retailer faces relatively higher uncertainty. We doubt that

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4 Electric Restructuring Act, G.L. c. 164, §1(c).

5 Electric Restructuring Act, G.L. c. 164, §1(k) (*emphasis added).*

these portfolio scale economies are significant, however, given that retailers have been able to compete very successfully with regulated default service for industrial customers. Unless wholesale electricity markets are uncompetitive, it does not seem that a retailer would fare any worse in acquiring wholesale energy than a large default supplier operating under a procurement model.[6]

The other retailing functions to consider are the administrative ones such as billing, settlement, and customer service. Unlike wholesale contracting, these functions have a relatively high proportion of fixed costs. We may suspect that larger retailers might, indeed, have lower administrative costs per customer served. An important question, however, is whether the current distribution utility is the best candidate to become the provider of such administrative functions. Continued regulation, for example, may specifically forbid transferring such functions to a *larger* retailer who can achieve greater cost savings. Indeed, one potential outcome is the use of third-party billing agents with regional or national scope, performing certain administrative functions on behalf of local retailers. Retail competition would not necessarily require retailers to perform all retail functions themselves, but merely to arrange for their provision by efficient suppliers with the investment and scale to do it at least cost.

Therefore, even if there are some economies of scale in these billing and administrative functions, it is not clear that these scale economies will be captured by assigning default supply to incumbent distributors. While this may have merit as part of a short-term transitional mechanism, such a design eliminates the role of competition in providing incentives to reduce costs and provide superior service.

We also find it timely to clarify some confusion surrounding two separate concepts: incumbency versus true scale economies. It is very likely that, due to informational and transaction costs, most small customers will not switch unless there is a cost savings or other advantage. This is due not to cost advantages but rather to an inherited incumbent position: the initial burden to offer a discount falls disproportionately on new retailers. This does not imply that competing retailers will have higher costs than incumbents – the opposite is likely to be true. Over time, the pressures of competition will ensure that retailers achieve lower costs than incumbents, or else they will not survive. Competition will also ensure that these cost savings will be passed through to customers over time, as is envisioned in the Act.

None of these long-term cost savings can be realized for customers if the default service design makes it impossible for competing retailers to match the default rate offered by the distribution utility. Such a policy would secure a short-run advantage at the expense of the longer-term benefits of retail competition, in which competitive pressures will be exercised to lower customer costs in a sustainable way.

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[6] In fact, one would expect that a retailer might have strong incentives to cut procurement costs, since these can flow through to its profits. These incentives are difficult to replicate in an inflexible procurement auction model, in which the default supplier is locked into purchasing in a series of quarterly or annual auctions. A procurement pass-though model provides weak regulatory incentives for cost controls.

3 A competitive vision for Massachusetts

Retail competition replaces direct regulation with competitive pressures as the principal mechanism for ensuring consumers pay fair and low prices for electricity. This competitive pressure stems from the free interaction of multiple retailers, and the potential entry of still others, all of whom are vying for the opportunity to provide retail electricity service to customers. While specific measures to protect customers from inappropriate behavior may be required indefinitely, the basic logic of retail competition is simple and straightforward. As in other areas of the economy not characterized by conditions of natural monopoly, competition is more effective over time in delivering superior quality and lower prices to customers than direct regulation.

The most obvious way for retailers to secure customers is by offering better service or a lower price than other retailers. If customers can freely leave their current retail provider in favor of another, all retailers will engage in an ongoing effort to improve their service and lower their prices, either to gain new customer or simply to retain existing ones in the face of similar improvements by competitors.

Naturally, such an environment of robust competition will not develop instantly, and customer protections, such as default service, are necessary until such time as competition is firmly established. The path to such a result is particularly long in electric retailing, since the starting point is that of a single monopoly provider: the polar opposite of the multi-firm competitive environment just described. In Section 4 we address some essential steps in the transition to competition, but in the remainder of this section, we examine more carefully what a properly designed, competitive retail market might look like.

3.1 Multiple competing retailers

How would prices be determined in a competitive retail market for electricity? This question is critically important if a transitional mechanism is to attempt to mimic such prices. A useful starting point to this answer is the standard economic refrain: prices will equal marginal costs, as long as these are above average costs. Marginal costs will consist primarily of wholesale energy costs, as well as incremental administrative costs, particularly if the retailer undertakes metering, billing and collections functions. For the business to remain viable, retailers will also need to recover other on-going costs, even if these are fixed relative to retail load, such as staff salaries and general administrative costs. Failure to recover these costs will lead to exit by some retailers, diminishing competitive pressure and allowing prices to rise to levels consistent with average cost recovery by efficient firms.

It is important to recognize the dynamic impact of these on-going costs of the retail business.[7] While they are not marginal costs in the strict sense, they do define the exit condition for firms

[7] We focus only on recurring non-variable costs that continue to be incurred on an on-going basis. Additional costs may have been incurred to enter the market in the first place, such as developing customer account systems or other investments. Recovery of such sunk costs, while a necessary expectation for entry, is not a

in the market. If retail prices are only sufficient to recover marginal costs, the retail market will simply fail to attract and retain competing firms, without which there can be no competition at all.

In a competitive market in which a stable number of retailers has been achieved, we would expect retail prices to be just sufficient to cover:

- Wholesale energy costs;
- Wholesale energy contracting premiums;
- Direct costs of metering, billing and settlement functions, if performed by the retailer;
- Customer acquisition costs, including rebate incentives, marketing and other promotional efforts;
- Other general and administrative costs; and
- Normal profit commensurate with the risk of the business.

These costs would be expected to be the lowest cost achievable that is consistent with maintaining standards of service; in other words, these costs should be close to the industry's best practice. Poor contracting or excessive administrative costs will inflate a retailer's prices or reduce service quality. Such retailers will either lose market share or need to make improvements.

We also assume that all retailers face these costs. For example, retail competition would be difficult in the presence of a single large retailer who already had most of the market share. Such a dominant firm would not need to incur any costs to acquire customers (it already has all of them) and therefore can offer a price no other retailers can match. Such dominance may translate to an insurmountable cost advantage and deter new firms from entering the market, stifling competition.[8]

3.2 Minimal reliance on default service programs

The hallmark of a successful transition to retail competition is a reduced reliance on regulated retail service options such as the current default service. Since competing retailers must constantly out-do each other to acquire and retain customers, the successful firms will be quite adept at developing various pricing options to suit different customer preferences. Default service prices may be acceptable, but the best deals and the most suitable programs will be found in competitive service.

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requirement for avoiding exit. Since retailing is the least capital-intensive aspect of the electricity business, we expect recovery of past investment to be secondary in importance to recovery of on-going costs.

[8] In some cases, prices may still be effectively disciplined by the *potential* entry of new firms. However, if the dominant firm can credibly threaten a price war with any new entrant (which it will win due to its low customer acquisition costs), entry will not occur even if the dominant firm sharply raises prices.

As discussed more completely in Section 5, the UK provides evidence that, once retail competition is fully established, direct default service price controls can be eliminated. Important customer protections must still be maintained, but this might take the form of competition policy, oversight of marketing and contracting practices, and other protections necessary to ensure the integrity of market behavior rather than control of market outcomes.

3.3 Separation of distribution wires and supply functions

Important benefits may be derived from a separation of the asset-intensive distribution "wires" function from the default supply function. In principle, it makes sense to have these functions bundled only if there are economies of scope – that is, if it is less costly to provide both functions within the same firm than by two separate firms. The nature of the two functions suggest that the economies of scope between the distribution wires function and retail and default supply are in fact limited:

- **The skills required are very different:** The procurement, customer management and billing functions have limited skills overlap with the distribution asset ownership and operations business. The skills and employees needed are very different, as are the required management structures. Retail businesses focus on systems and intellectual capital, while wires businesses are characterized by a focus on cost reduction, operations, and efficient capital investment in the network.

- **Scale economies are different:** Scale economies may be exhausted at relatively low levels in network distribution industries, but may be higher in billing and customer service activities. It is generally considered that a distribution wires company serving only a few hundred thousand customers will already have achieved most of the scale economies for that business. This may not be true in billing and customer management activities, due to the large proportion of fixed costs related to software and systems.

These attributes suggest that the advantages of bundling default supply along with the distribution wires function are unlikely to produce substantial cost savings or lower customer rates. On the other hand, there are reasons to believe that separation of default supply and distribution function may lead to lower rates and regulatory costs.[9] First, separation ensures that the retailing operations of the utility are not subsidized by shifting costs to the regulated distribution wires business. In the UK, OFGEM has required that the supply functions of each Public Electricity Supplier (PES) be separated from the wires functions to alleviate these and other concerns.[10] The separation of the distribution and retail functions will require the appropriate identification and allocation of administrative costs.

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[9] Lower regulatory and oversight costs are an explicit objective of the Electric Restructuring Act. See G.L. c. 164, §1(f).

[10] OFGEM, "Separation of PES Businesses: Review of C12 License Obligations Consultation Paper", February 2001.

Second, separation may allow a lower cost of capital for the low-risk, asset intensive distribution wires business. Absent any procurement and pass-through risks related to default service, distribution wires businesses have a very low risk profile, and can be highly debt financed. This change in risk structure could be accompanied by a change in financial structure, producing a significantly lower weighted average cost of capital (WACC). For the asset-intensive distribution business, a change in the WACC could have a major impact on customer rates.

The experience with utility "wires and pipes" businesses internationally is instructive here. Once distribution functions have been ring-fenced into low-risk asset management and operation businesses, it has often been possible to increase the proportion of debt finance significantly, which can cut the cost of capital.[11]

The UK water sector provides such an example. In response to the strong efficiency targets announced by the UK regulator, many companies have increased their leverage significantly, while several have proposed or moved to highly leveraged structures in an attempt to cut financing costs.[12] Fitch/IBCA, the international rating agency, opined in a 2000 report that moving to debt-financed structures might allow the regulated water companies to reduce their post-tax WACC from 4.75% (for a 50% debt-financed entity) to as low as 2.8-3.5% post-tax (for a primarily debt-financed structure).[13] Such a reduction in financing costs would translate to significant drops in distribution charges over time.

Such structures may not be possible if there is perceived risk associated with default service procurement obligations attached to the distributor. In recent years the financial community – especially the influential credit ratings agencies - have expressed the sentiment that very low risk "wires and pipes" businesses can attract the lowest cost of capital on a standalone basis.[14]

In the current financial environment, one might expect strong investor appetite for low-risk, long-dated debt securities associated with ring-fenced regulated wires businesses. By separating all default supply and other obligations, the costs of financing the existing distribution wires assets and financing additional investment might fall. This could yield a substantial benefit to customers in the Commonwealth.

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[11] Debt finance is usually a more tax efficient structure for low risk businesses, as dividends are generally taxed while interest payments are not. This practical aspect changes the results of the usual Modigliani-Miller analysis, which suggests that increasing leverage should not lower the WACC. See Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment", *American Economic Review*, vol. (June 1958)

[12] The experience of the UK distribution businesses is less instructive, as most have been absorbed into large American or European diversified utility groups.

[13] Fitch IBCA, "Water Divining: What's Next for the UK Water Sector", June 2000.

[14] Standard & Poor's, "Quest for Value Forces UK Water Sector to Restructure", 2000.

4 Critical elements of transitional mechanisms

Successful transitional mechanisms must achieve at least three goals:

- Create market rules that prove attractive to potential new retailing firms;
- Protect consumers from excessive pricing while competitive pressure is weak; and
- Maintain standards of service and ensure a smooth migration of business functions away from monopoly distribution companies.

Additionally, transitional mechanisms may involve new retailers in providing default service, rather than leaving them only the role of being the alternative to regulated service. Such an inclusive design may provide a lower-risk entry option for new firms, creating a 'training ground' that ensures there will be numerous retailers in the market at the end of the transition period.

4.1 Transitional considerations: price protection and new entry

Any transitional mechanism, to be true to its name, must facilitate the fundamental change required of the industry in order to achieve its intended goal. In the case of retail competition, this fundamental change requires the introduction of multiple retailers, each vying to serve electricity consumers in the Commonwealth. Lacking any authority to compel such entry, it is self-evident that the potential to earn a profit is an essential pre-requisite to achieving this structural change. A minimum requirement for any transitional mechanism, therefore, is that it not preclude efficient new retailers from earning a normal business profit.

Of course, it is also undesirable for consumers to face unrestricted prices right away. In the initial period of limited competition, consumer safeguards including a regulated default rate may be appropriate. Default prices must therefore serve the dual aims of disciplining retailer pricing while preserving the business opportunity that will ultimately attract competitive retailers. In the UK, the analysis of retailer "headroom" was an explicit consideration in setting supply price controls until these were recently eliminated.[15]

4.2 Massachusetts transition should focus on market structure, not just price control

The dual aims of preserving the scope for retail entry while protecting customers can be achieved by mandating the provision of regulated default service at a price that implies normal profits to an efficient new retailer, but effectively limits the ability of any default retailer to demand prices in excess of this level. Ideally, potential entrants would recognize that such a retail market offers the potential for reasonable profits, even in the presence of a regulated default service.

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[15] OFGEM, "OFGEM's Analysis of Possible 'Headroom' in Domestic Gas and Electricity Retail Supply", 2001.

Transitional mechanisms need not be so passive about encouraging market entry, however. Instead of leaving new retailers to play the role of the "alternative" electricity provider, new firms can be directly involved in providing the regulated retail service itself. This has at least three appealing attributes. First, it allows new retailers to enter the business and carry out some of the critical retail functions without needing to be a full-blown competitive retailer. Retailers providing default service, for example, may face significantly less uncertainty about the number of customers they will acquire, of the load they will need to serve. Furthermore, if the distribution utility continues to have a role in some of the administrative functions of regulated retail service, the retailer may be able to enter the business before acquiring the full complement of business skills, billing and settlement systems, or customer service infrastructure necessary for a stand-alone retail business.

A second advantage of having new retailers providing default service is that it helps to change the consumer expectations about whom, precisely, their supplier really is. To the extent some consumers stay on default service solely due to the name recognition of the incumbent utility, having default service provided by new retail companies can help eliminate this bias. Finally, since default customers will be split among multiple retailers, such an approach is a proactive step to fragmenting the retail market share – an important pre-requisite to robust and effective retail competition.

5 An example of a successful default service mechanism

The United Kingdom provides an excellent case study in a well-designed transitional mechanism that has delivered robust retail competition and substantial customer benefits.

The stated objective of the UK regulator OFGEM is to "protect the interests of customers, wherever appropriate by promoting effective competition."[16] In Massachusetts the affordability of electricity for lower-income residents is an explicit objective of restructuring[17]. In comparison, in Britain OFGEM has an explicit responsibility to lower-income and other vulnerable consumers to the extent that competition does not deliver these benefits on its own. In the UK, much of the success of retail competition in providing customers energy at low cost may be traced to the development of economic structures that have stabilized prices for customers over a transitional period, while allowing competitive forces to develop.

5.1 The retail transition in the UK

For smaller electricity customers, the transitional mechanism used in England and Wales had several key components:

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16 Office of Gas and Electricity Markets (OFGEM), "Review of Domestic Gas and Electricity Competition and Supply Price Regulation", November 2001, p.2.

17 Electric Restructuring Act, General Laws c. 164, §1(n).

- By May 1999 all electricity customers – including small residential and commercial customers - were made eligible for the retail market. Competition for larger customers had been previously established.

- The local incumbent supplier – the entity holding the Public Electricity Supply license for a defined area - served all default customers.[18] The prices that could be charged by an incumbent supplier were capped for an initial period of two years.[19]

- A maximum regulated retail price for each default supplier was calculated, which acted as a cap on default service prices (known as the "supply price control"). Other suppliers were always able to make competing offers to these customers.

A simplified timeline of the transition for smaller customers is illustrated in Figure 2. In 2001, OFGEM investigated the state of the retail markets, in preparation for a determination of whether the existing supply price controls should be extended, modified, or lifted. The conclusion, published in November 2001, was that retail competition was "well established, effectively protecting customers' interests, and continuing to develop well."[20] This was based on the following observations:

- Over the transitional period, around 38% of domestic electric customers had switched to a competing supplier. The level of switching across customer groups was assessed and found to be satisfactory.

- A significant number of competing suppliers were found to be making offers to residential customers. Many of these suppliers were offering substantial discounts to attract customers.

- While OFGEM still found there to be some barriers to entry in the retail market, these were determined to be limited in nature.

Consequently, in April 2002, OFGEM lifted the final default service price control and opened the market to full competition. Protections are still provided to customers under the Competition Act, which OFGEM is empowered to enforce with respect to electricity supply.

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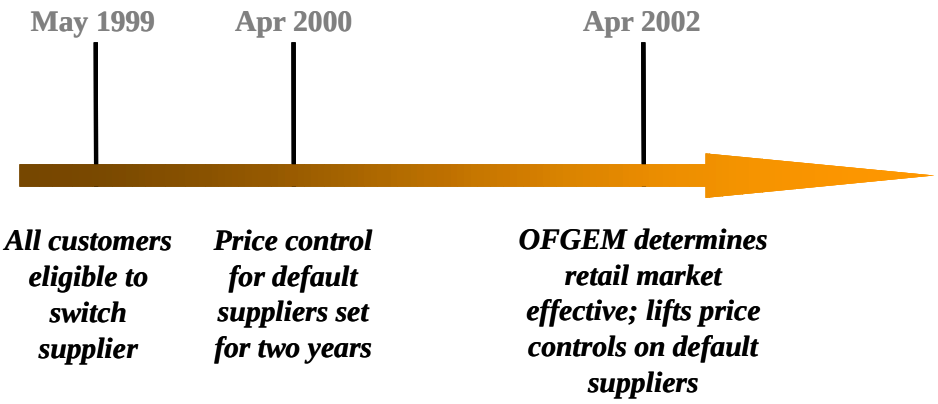
[18] The term "default service" is not used in the UK. The use of this term in this paper with regards to the UK refers to smaller customers that, although eligible to switch suppliers, had not yet done so. In this case, OFGEM required the host supplier to serve these customers at no more than a maximum "default service" rate.

[19] The price control cap was extended in 2000; supply price controls had been a feature of the regulatory system since the initial restructuring in 1990. OFGEM determined that the supply price control should be lifted in April 2002, as the retail market was now sufficiently developed to protect customers, with the other restrictions and protective measures in place.

[20] OFGEM, p. 97.

Figure 2: Recent simplified timeline of small customer retail transition in the UK



5.2 Setting the maximum default supply price

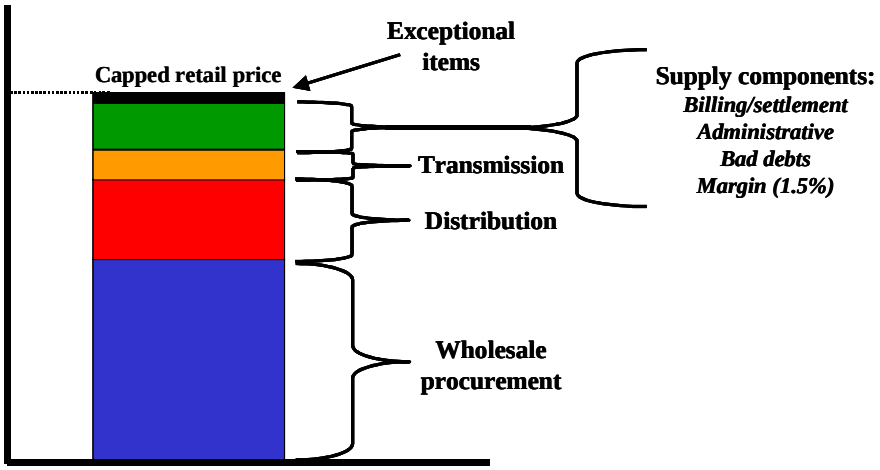
The task before OFGEM in designing its supply price controls was similar to the task that is currently facing the Department: setting forward-looking prices for default customers that meet the twin objectives of protecting their interests while allowing retail competition to develop.

The OFGEM supply price controls take the form of price restraints – maximum prices that can be charged to default customers for a set period (in this case, two years). The price was indexed in the second year through an RPI-X formula.

The default supply price for each supplier was built up from the individual cost components, as is shown in Figure 3. The fundamental structure of the supply price control remained largely unmodified from 1999 to its final abolishment in 2002.[21]

[21] OFGEM, "Reviews of Public Electricity Suppliers 1998 to 2000: Supply Price Control Reviews: Initial Proposals", October 1999.

Figure 3: Calculating default service prices from costs (not to scale)



Several features of this supply mechanism are relevant to the current DTE investigation:

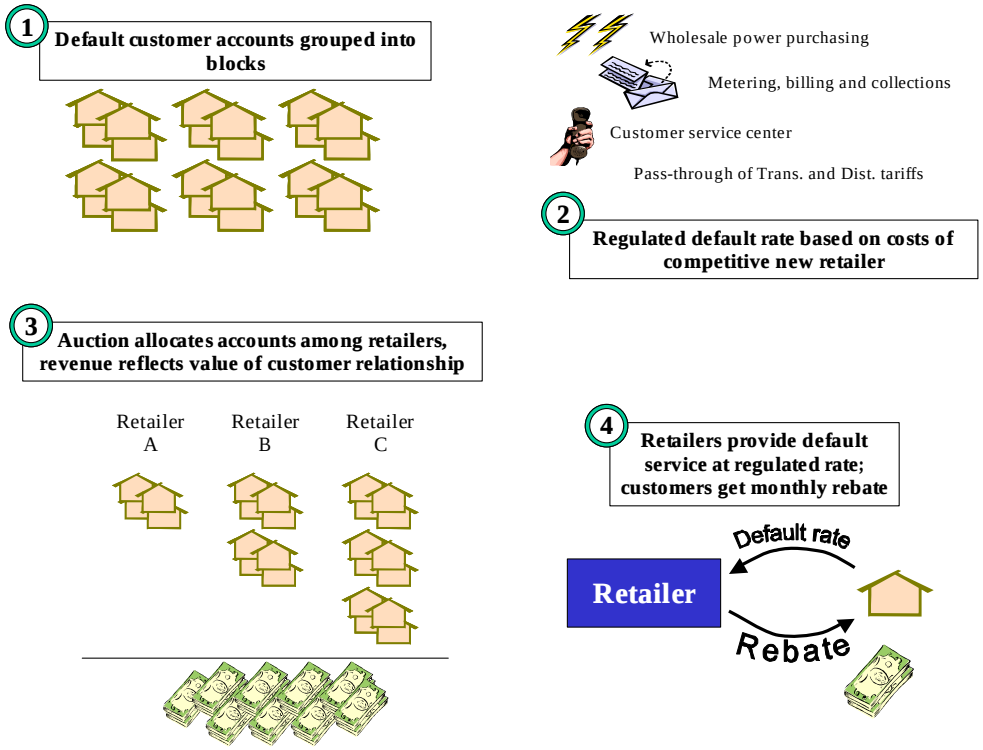
- OFGEM considered – but rejected – a mechanism that would allow default suppliers to pass-through their competitive procurement costs directly. Instead, OFGEM determined that a single procurement portfolio cost (developed using wholesale market costs plus a contracting premium) would be appropriate.[22] This method would provide default suppliers with incentives to cut their wholesale procurement costs.
- Regulated transmission and distribution charges were passed-through directly.
- The supply costs of the various default suppliers (e.g. administrative, procurement, billing and settlement and credit costs) were compared to each other, to determine a base supply component (e.g. based on average costs for these functions across the suppliers). By building in an average allowance, the worst-performing suppliers were given a strong incentive to reduce these costs.
- Finally, a small margin was built into the supply price control, in recognition that under this mechanism does not guaranteed full cost recovery to retailers (due to volume and other risks). The combination of industry average retailing costs plus the inclusion of a retailing margin achieves preservation of headroom, allowing competitive retailers to match or beat the default price.

[22] This price had to be adjusted for load profile, variations in loss factors, etc.

6 The Centrica proposal

In this section we discuss the main elements of Centrica's proposal for transitional default service. It is consistent with the specific goals set forth in Section 4, as well as the objectives articulated by the Department in its June 21st Order. The main elements of the proposal are outlined in Figure 4.

Figure 4: Overview of Centrica proposal for default service



The Centrica proposal is characterized by the following elements:

- The default service price charged to default customers is set to replicate the price that a competitive retail entrant would charge, given prevailing wholesale market conditions and appropriate indicators of retailing costs. This ensures the default price mirrors as closely as possible the market price for retail electricity service.
- Having established the default service price, retailers would be able to acquire blocks of default customer accounts at an auction. Customer accounts so acquired would be served, at the regulated default price, for the duration of the transition period or until that customer elects to leave default service in favor of competitive retail service.
- The auction revenues would fund a customer rebate program whereby all customers receive an offset to their monthly electricity bill. Auction revenues represent the value of

having acquired a customer account, and the rebate ensures this value is returned to the customers themselves.

- Retailers acquiring default customer accounts would not only purchase wholesale energy to serve these customers, but would have the primary customer relationship for all aspects of retail service. To the extent it is considered necessary for the distribution utility to conduct some of these additional functions, retailers may initially be required to outsource such functions to the distribution utility.
- At the end of the transition period, customers would continue to be served by the same retailer that provided default retail service during the transition period, though retail prices would no longer be regulated. If it is determined that there is still insufficient retail competition to warrant lifting of regulated prices, a new default service rate could be established on the same basis as contemplated for the transition period.

6.1 Forward-looking market pricing

Under the Centrica proposal, the regulated default price for default customers will be designed to replicate the retail price that would be offered by a competing, unregulated retailer for similar customers and for a similar term. For example, if it is determined that default price should be set at a fixed level for a two-year transition period, the guiding principle for setting the price would be to estimate the price a retailer would be able to offer for similar service under competitive market conditions.

Two issues must be addressed in setting the default price:

- At what price can the wholesale energy requirements be secured for the proposed term?
- What additional costs – including normal profit – would a competitive retailer need to recover from the retail price in order to provide such service?

The first question can be addressed through wholesale forward markets. While forward markets for electricity in Massachusetts are still developing, there is reason to believe that forward contracts will be available to hedge retail energy needs by new retailers. In New Jersey, the recent auction for Basic Generation Service secured wholesale energy contracts for delivery during August 2002 – July 2003, a period ranging from 6-18 months from the auction date.

Even longer-term hedges do not appear to be overly difficult to secure. In the recent round of Standard Offer procurement, utilities in Maine were able to secure fixed-price wholesale energy contracts for terms of three years.

The second question, relating to other retailing costs, can be informed through comparisons to similar firms in other jurisdictions. Information from competitive retailers was used in both the UK and Australia for setting the default service price in those jurisdictions. Broad estimates of monthly costs per customer, variable costs depending on consumption, as well as allowable profit margins on wholesale contracting and retailing costs can be developed. This is not an exact science, of course, and the ultimate test of the validity of these estimates will be whether retailers actually enter the market.

Centrica proposes that wholesale procurement component of the default service price be fixed for a period of two years, to be revised as part of the process anticipated when Standard Offer expires in 2005. The wholesale energy component can be estimated from forward market activity in peak, off-peak and baseload contracts. The fixed nature of the default price reduces uncertainty to retailers providing default service, as well as avoids the need to develop a mechanism for interim adjustments to the default price.

The retail business cost component of the default price should also be fixed for the entire transition period. Retailing business costs are best known to the retailers themselves. Their participation in the process can be taken as credible evidence that these costs are not excessively low, while an overestimate of these costs will ultimately be remedied through competitive switching.

6.2 Create full customer relationships with default service retailers

In addition to managing a wholesale energy procurement portfolio, competitive retailers must also manage all aspects of the customer relationship. This includes providing customer service, performing all billing and collections functions, resolving billing or accounting disputes, and serving as a billing agent for certain pass-through costs. The role of the distribution utility becomes largely invisible to consumers, much like ownership of long-distance telephone wires is invisible to callers today.

During the transition, default service retailers may not immediately adopt all of these functions. Nevertheless, every effort should be made to recast the customer relationship as one between the default customer and the retailer, rather than with the distribution utility. Even if the distribution utility retains initial responsibility for metering or settlement, communications with default customers (such as bills, correspondence, call centers) should bear the name and logo of the default retailer. Customers should write and mail their monthly checks to the retailer; they should call the retailer to report service problems, request disconnection or record a change of address. To the extent the distribution utility continues to provide certain functions necessary to retail operations, these should be invisible to consumers, as this is the long-term vision under retail competition.[23]

As a valued part of the retail relationship, retailers should be allowed to use billing activity to promote and advertise other competitive services. This is the same right that retailers would have with respect to competitive supply customers, and is similar to other promotional activity seen in other sectors such as credit cards and long-distance telephone service. Prohibitions against such promotional usage would create a bias towards default service by customers wishing to avoid such inserts, as well as depriving competitive retailers an opportunity to distinguish themselves through limitations on such activity. Preserving such promotional

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[23] As previously stated, careful consideration will need to be given to the cost allocation between the utility's distribution and retailing functions. Misallocation of these costs will either create an artificial cost advantage to the unregulated retail business, or saddle it with excess costs that make it uncompetitive.

opportunities will increase retailer interest and the value they place on serving default customers.

6.3 Post-transition provisions

Upon termination of the transition period, default customers will remain with the retailer that provided default service during the transition period.[24] This is critical to avoid re-creating the present dominant position of distribution companies. Furthermore, if distribution companies face the prospect of re-acquiring all default customers at the end of the transition period, they will be unable to unwind and dismantle their existing retail operations. Returning default customers to their present utility would prevent a permanent separation of distribution and retailing functions.

Finally, retailers will be less willing to invest efforts into developing brand recognition and customer loyalty if their customers will simply revert back to the distribution company at the end of the transition period. Retailers place significant value on establishing direct relationships with customers, and any provisions that undermine such a relationship will come at the expense of retailer interest or participation in the transition process.

6.4 Account acquisition auction design

Having established the default price, as well as the nature of the relationship between default customers and their retailers, Centrica proposes an auction mechanism for selecting the retailers that will serve the default customers. In addition to allocating customer accounts among multiple retailers, the auction will reveal the value retailers place on serving the default customer accounts.

The auction itself is relatively simple. Customer accounts will be categorized on the basis of geographic location, average and peak monthly consumption, customer class, or other characteristics deemed commercially significant. With the forthcoming implementation of locational marginal pricing (LMP) by ISO-NE or its successor, customer location will likely become a major determinant of wholesale costs, even within the same service territory.[25] The appropriate grouping of locations should be given significant consideration to avoid inadvertent averaging of wholesale costs. Such averaging would charge one sub-group of customers an artificially inflated price, depriving them of the customer protection benefits intended by default service, while charging another sub-group an artificially depressed price, stifling the prospects for meaningful retail competition.

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[24] Such a provision requires a favorable determination that this would not constitute unauthorized switching of customers from their current service.

[25] LMP is a major component of the NEPOOL Congestion Management System (CMS) currently being implemented in New England. The use of LMP for congestion management is also mandated in FERC's Notice of Proposed Rulemaking on Standard Market Design, released on July 31st, 2002.

Once properly characterized, similar accounts are bundled into one or more blocks, with each block representing a similar size of aggregate load. The number of blocks is driven by a desire to allow retailers to participate even on a relatively small basis. An auction is held for all blocks of a particular customer category. Where multiple types of customer blocks are created to reflect different commercial attributes, a separate auction will be held for each customer category.

Retailers participating in the auction will submit bids for the right to acquire the block of accounts and serve those accounts at the default price during the transition period, or until a customer elects to switch to competitive retail service. Since bids represent what a retailer will pay in order to acquire the customer accounts, the auction clears at the lowest bid necessary to allocate all blocks in the auction to participating retailers.

As in any auction, parameters such as minimum bids, maximum number of blocks that can be acquired by any one retailer, or the potential to allocate fewer than 100% of available blocks will need to be determined in advance of the auction. Specific auction rules will also need to be developed and tested. Given the popularity of auction mechanisms as well as their successful application in recent electricity sector efforts, we foresee no difficulty in developing and implementing a successful auction design.

This auction proposal is distinct from one in which retailers bid on the basis of the price at which they will serve default customers. In such an auction, the default price is not set in advance but rather determined in the auction itself. The difficulty with that type of auction is that the resulting default price will not reflect the customer acquisition costs avoided by participation in the auction. In other words, the auction-clearing price will likely be lower than the price a new retailer would offer when attempting to lure default customers onto its competitive service. Such an auction would be inconsistent with the objective of setting default prices that are compatible with a transition to retail competition.

6.5 Auction revenues and customer rebates

Revenues obtained in the auction represent the value of the customer relationship to retailers. This is quite separate from the normal profit on actually providing retail service to consumers, which is already embodied in the default service price. If retailers value not just the profit stream from providing retail service, but the customer relationship itself, then this value will be reflected in the revenues if the auction is competitive. It would therefore seem appropriate to return these proceeds to the very customers from which this value stems.

There may be a second reason why retailers would be willing to pay to acquire customers: serving them at the default price implies profits greater than simply a normal return. If the default price has overestimated any of the cost elements discussed in Section 3.3, retailers will be willing to pay to acquire customers on such attractive terms. In this case, too, it would seem

appropriate to return the auction proceeds to customers, as this would tend to mitigate the fact that the default price may have been set somewhat high.[26]

Under the Centrica proposal, auction proceeds would be returned to customers through levelized monthly rebates to their electricity bill. Each customer would get a fixed rebate, rather than a reduction in their per-kWh consumption charge. Structuring a rebate on a fixed monthly basis would preserve consumption and conservation incentives, and would ensure all customers share in the rebates equally.

6.6 Additional considerations

During the transition period, it is unlikely that no new default customers would emerge. New default customers may be the result of people or firms coming into the Commonwealth, setting up an account for the first time in their own name, or switching away from their previous retail service. Similarly, at least some of the default customers at the time of the auction are likely to leave default service at some point during the transition period, either because they elected competitive service or left the state.

Centrica proposes that winning default service providers be allocated all new default customer accounts, provided they are of the same commercial attributes as those accounts acquired in the auction. Where multiple retailers are serving default customers similar to new default customers, the new accounts will be allocated in proportion to the number of blocks acquired in the auction.

This approach has the advantage of not relying on the distribution utility to provide any default retail service at all, consistent with our goal of allowing distribution utilities to get out of the retail business. Additionally, the stream of new accounts may partially offset the attrition of similar accounts.

The only exception to the allocation of new default customers to the default service providers is the anticipated major influx of new default customers upon the expiration of Standard Offer in March 2005. Centrica proposes that former Standard Offer customers be allocated to default retailers through a second auction process, similar to the one proposed here for existing default customers. Such a large influx of default customers provides ample opportunity to introduce additional default retailers, further augmenting the number of retailers in the state.

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[26] This is only valid for modest overestimations of the default price. If the price is set excessively above new entrant prices, auction participants may be skeptical of their ability to retain these customers for the duration of the transition period. The high margins implied by such an above-market default price will be offset by expectations of high customer switching, reducing auction proceeds.

7 Conclusions

A successful transition mechanism must both facilitate the structural changes necessary for full retail competition in the future, while protecting consumers as competitive conditions emerge. Centrica proposes a transitional default service, with pricing based on what a competitive new entrant would offer under prevailing wholesale market conditions. This ensures that customers do not face abusive pricing, while preserving the business opportunities that are central to attracting new retailers and achieving the long-term benefits for retail competition.

Figure 5: Evaluation of the proposal against key criteria

Criteria		Comment
Compatible with efficient retail market?	☑	Allows entry by efficient retailers over the transition period
Promotes customer choice?	☑	All customers are allowed to switch over the transition; expect a robust transition
Provides short-run price benefits to small customers?	☑	Default customers benefit from auction rebate in transitional bills
Provides long-run price benefits to small customers?	☑	Allows retail competition to develop and hence competitive pressures
Accelerates transition to a competitive market, as envisioned in the 1997 Act?	☑	Provides final transition; ends price control at end of period if retail market working
Provides incentives for default suppliers to reduce procurement costs?	☑	Default providers have strong incentives to procure power at lowest cost

This default service design is evaluated in Figure 5 against key criteria identified in the Electric Restructuring Act and in the Department's June 21st Order. While no default service mechanism is by any means perfect, we believe this proposal does meet the key policy objectives identified by the Legislature and the Department.

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